SARSI LLC

Fourth Quarter 2019 Market Newsletter Summary

- All asset classes had strong performance in 2019
- Consumer spending and the services sector are supporting US economic growth. Uncertainty brought about by the trade war has dampened corporate confidence and the manufacturing sector is hurting.
- Easy financial conditions (Monetary and fiscal) and removal of several uncertainty brought about by Brexit and the trade wars should jump start global economic growth.
- US stocks are more expensive than in the past. Earnings growth and dividend yield will be the major contributors of future returns.
- Historically, big gains in stocks are not followed by big losses. Stocks exhibit tremendous amount of momentum especially in the last stages of a bull market.

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Table 1: Market indices

(Returns include dividends)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	9.07%	31.49%	31.49%	15.27%	11.70%
S&P Mid Cap 400	7.06%	26.20%	26.20%	9.26%	9.03%
S&P Small Cap 600	8.21%	22.78%	22.78%	8.36%	9.56%
MSCI Emerging Markets	11.93%	18.90%	18.90%	11.99%	6.01%
MSCI EAFE	8.21%	22.66%	22.66%	10.11%	6.18%
Investment Grade Credit (C0A0)	14.23%	14.23%	14.23%	5.94%	4.60%
Non-Investment Grade Credit (H0A0)	2.61%	14.41%	14.41%	6.32%	5.36%
Bloomberg Commodity Index Total Return	4.42%	7.69%	7.69%	-0.94%	-3.92%
Dollar Index (DXY)	-3.01%	0.23%	0.23%	-1.94%	1.32%
Vanguard Total Bond Market Index (VBMFX)	-0.0%	8.60%	8.60%	3.92%	2.90%
10 Yr Rate	1.68% 12/31/2019	2.00% 12/31/2019	3.06% 12/31/2018	1.61% 12/31/2016	2.51% 12/31/2014

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 01/10/2020			
	Latest Release	Recent Trend	Notes
Non Farm Employment	145,000	Positive	Less than expected jobs were added last month. Unemployment remained at 3.5%, the lowest in 50 years. Labor participation remained steady but has been trending higher. Wage growth over the last year was a tepid 2.9%
Weekly Claims for Unemployment Insurance	214,000	Positive	Unemployment claims continues to be very low. The four week average fell to 224,000
ISM Manufacturing Index (Number over 50 points to growth)	47.2	Negative	This is the worst reading since June 2009. Manufacturing in the US is contracting according to this index, possibly hurt by the uncertainty brought about by geopolitics and the trade war.
ISM Non Manufacturing Index (Over 50 points to growth)	55	Positive	This index has been perking up in the last few months. A majority of the US economy is non manufacturing, so this is of significance. All underlying areas (business activity, new orders and employment) are growing.

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	Latest Release	Recent Trend	Notes
Consumer Prices (Month over month change)	0.3%	Positive	Consumer prices rose by 0.3% in November and by 2.1% over the last year. Excluding the volatile food and energy items, prices were up 0.2% in November and were up 2.3% from last year. Inflation is still subdued.
Producer Prices (Month over month change)	0%	Positive	Producer price index was unchanged in November and was up 1.1% over one year. Excluding food and energy, producer prices were actually down 0.2% in November and were up only 1.3% for the year.
Retail Sales (Month over month change)	0.2%	Negative	Retail sales rose less than expected in November. Online retailers saw the biggest jump- non-store retailers rose 0.8%. Holiday sales reports since this index was released has been more positive- a report by Mastercard shows an increase of 3.4% from last year.
Consumer Confidence (Conference Board)	126.5	Positive	Consumer confidence has dropped significantly from the record high set in the summer of 2019, but is still quite strong. Consumers seem more confident of the present conditions than the future; the latter impacted the index negatively.
Durable Goods Orders (Month over month change)	-2%	Negative	New orders for durable good has been weak since the cyclical high set in the summer of 2018. The non-defense capital goods orders excluding aircrafts, rose marginally by 0.1%. Geopolitical uncertainty is probably preventing companies from making capital decisions.
Industrial Production (Month over month change)	1.1%	Negative	Industrial production spiked up 1.1% in November, helped by an end to the GM strike. Excluding motor vehicles and parts, industrial production improved 0.5%.
Capacity Utilization	77.3%	Positive	Capacity utilization improved in November, but is still 2.5% below its long term average.
Housing Starts	1.365MM	Positive	Housing starts were strong in November, and were 11.1% higher than a year ago. Lower mortgage rates are supporting housing activity.
Home Prices (Case-Shiller 20 city Index- Month over Month)	0.4%	Positive	Housing prices are increasing but at a slower rate. Year over year, housing prices improved by 2.2%
GDP (Real, Annualized)	2.1%	Positive	The third estimate of the GDP for the third quarter of 2019 remained unchanged. The economy continues to grow but at a subpar level.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org.

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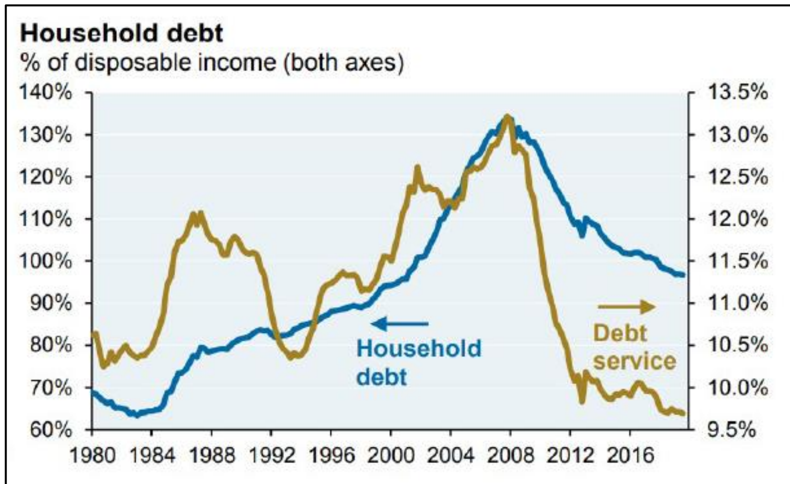
A strong fourth quarter capped off a year when almost all asset classes rose by double digits. After a disastrous fourth quarter of 2018, animal spirits returned to the markets in 2019, helped primarily by good news on the trade front and a dovish Federal Reserve (Fed), which did a U turn and cut interest rates three times during the year (After increasing interest rates as late as December 2018). US equities outperformed non-US equities, while stocks of larger companies outperformed those of smaller companies. The US 10-year interest rate dropped to a level that was a hair's breadth away from the all-time low set in 2016 and bonds delivered strong returns (Bond prices and interest rates move in opposite directions)

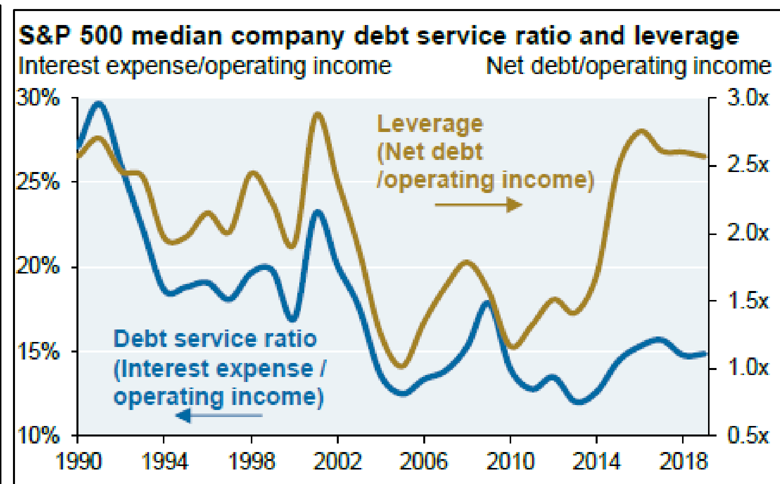
As seen in the table above, the US economy is a story of contrasts: consumers versus corporations and manufacturing versus services. As seen in Figure 3, CEO confidence has been dropping since 2018, while consumer confidence is high. Companies have been cautious in investing in their businesses, but consumers are in very good shape helped by a strong job market and are continuing to spend. What is also interesting is that while companies have been taking on more debt since the 'great recession' of 2008-2009, consumers have been repairing their balance sheet by reducing debt as seen in Fig 1 and 2. However, the debt servicing burden of both corporations and consumers is reasonable because of record low interest rates that have reduced the cost of debt significantly. Consumer are also saving at a healthy rate.

Fig 1: Household debt and debt service



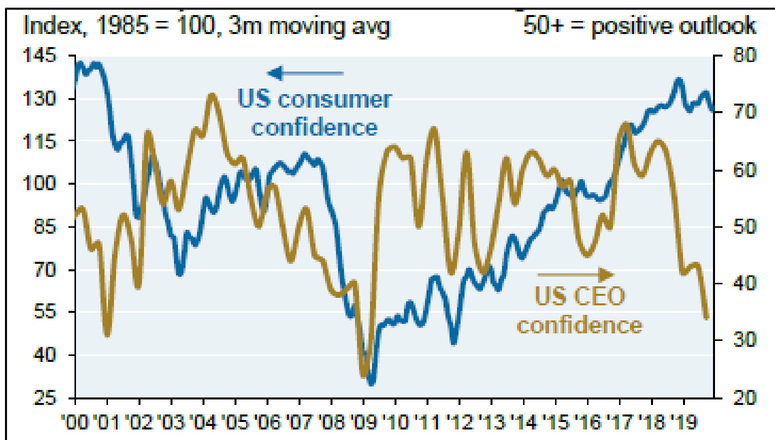
Source: JP Morgan, Federal Reserve

Fig 2: US company leverage and debt service



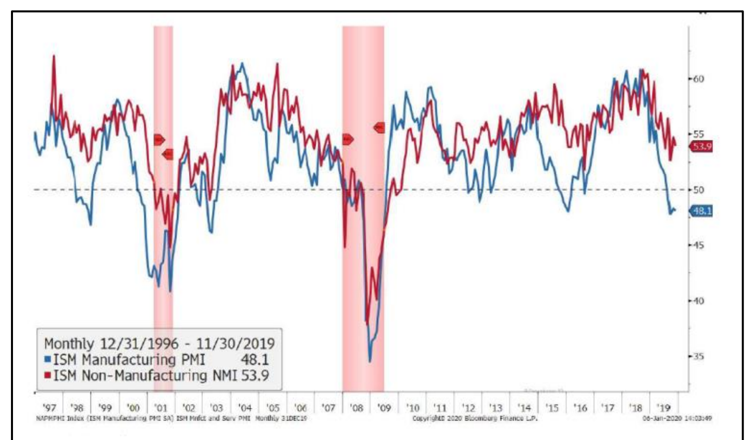
Source: JP Morgan, Bloomberg

Fig 3: US consumers are more confident than CEOs



Source: JP Morgan, Conference Board

Fig 4: US services sector doing better than manufacturing



Source: Doubleline, ISM

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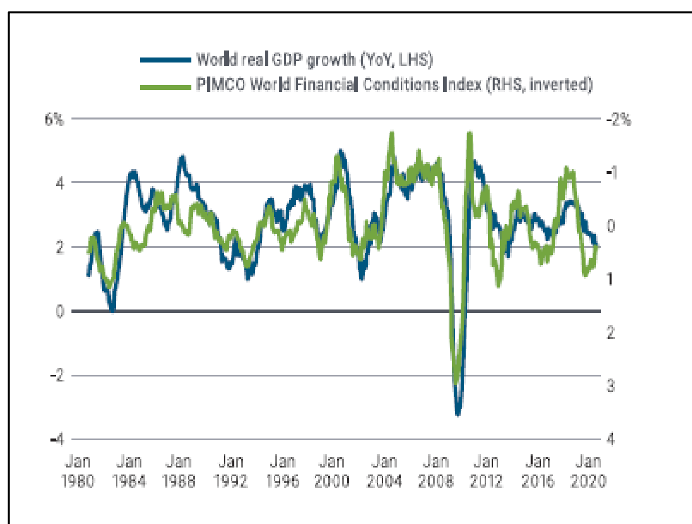
As seen in Fig 4, the manufacturing sector is hurting, because of the uncertainty brought about by the trade wars, but the services sector is in better shape. While both are off the highs set in 2018, the services sector is still expanding (as indicated by the ISM non-manufacturing index which is above 50), but the manufacturing sector is contracting. The US economy is primarily dependent on consumer spending and is made up of services more than manufacturing, as a result the US GDP is still growing- in the third quarter of 2019 US GDP is estimated to have grown by 2.1%. The Phase 1 trade deal signed by the US and China should ease some of the uncertainty in manufacturing and lead to an upswing in economic activity, helped further by easy monetary conditions

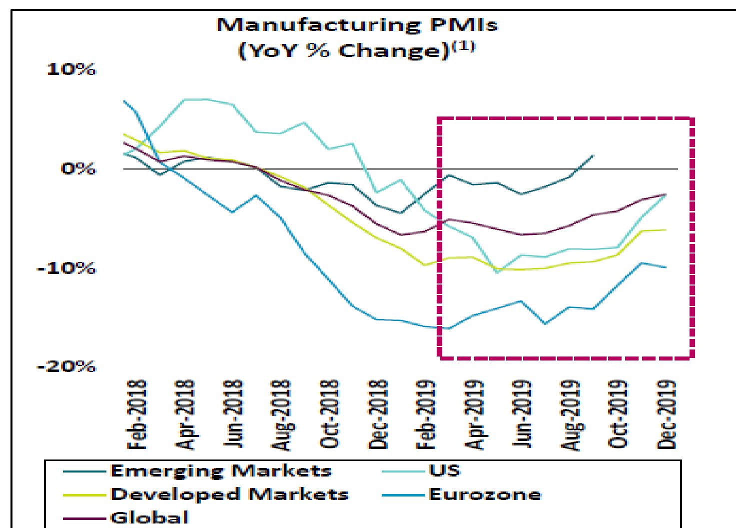
Globally too, the removal of uncertainty and easy financial conditions should lead to growth turnaround stories. As seen in Fig 5, supportive monetary and fiscal policies (Especially in China, Europe and Japan) have eased global financial conditions, usually a harbinger of economic growth. A ceasefire in the trade wars, should have a bigger positive impact on the rest of the world than the US, since economies in Europe, Japan and the Emerging markets are much more dependent on trade than the US is. Additionally, the passage of Brexit through the UK parliament should remove a major source of uncertainty in Europe. As seen in Fig 6, there are already signs of improvement in the manufacturing indexes. Reflecting the improving conditions, the total composite leading economic indicator for OECD countries has perked up for the first time in 2 years avoiding a level below 99, which has historically coincided with global recession.

Fig 5: Global financial conditions should support growth



Source: *PIMCO*

Fig 6: Global Manufacturing PMIs improving



Source: Blackstone

Despite the green shoots of optimism, there are several risks to the fragile economic recovery, which has primarily been engineered by unprecedented monetary stimulus by global central banks. It can be argued that the central banks have reached the limits of what they can do with monetary policy tools. (Although several central bankers have recently argued that they have several other options if required). Other risks to the economic recovery are, higher inflation, a return of trade tensions, geopolitical uncertainty especially pertaining to the middle east, surprise election outcomes especially in the US and a further worsening of the manufacturing sector.

In the US, fourth quarter 2019 earnings are beginning to be released, and analysts expect earnings to fall by 2.1% from last year. However, historically companies perform better than analysts expect. Only 9% of the companies in the S&P 500 have released earnings so far, and most of them are beating expectations. Revenue growth is expected to be 2.7% and a higher number of companies are beating revenue estimates than expected. For the entire year 2019, corporate earnings is expected to be flat (+0.2%) and revenue is expected to be up 3.9%. For the first and second quarters of 2020, analysts are

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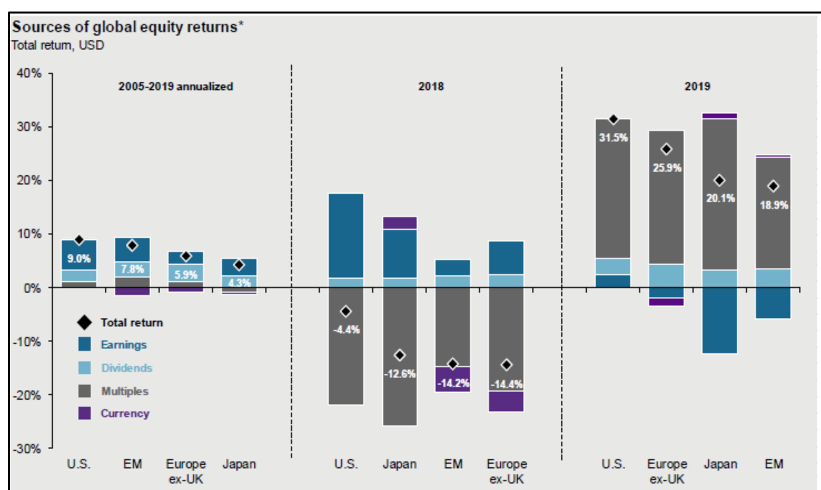
expecting mid-single digit earnings and revenue growth. (All numbers are from Factset). Profit margins of US companies have been falling, so stock buybacks and revenue growth will have to support earnings growth.

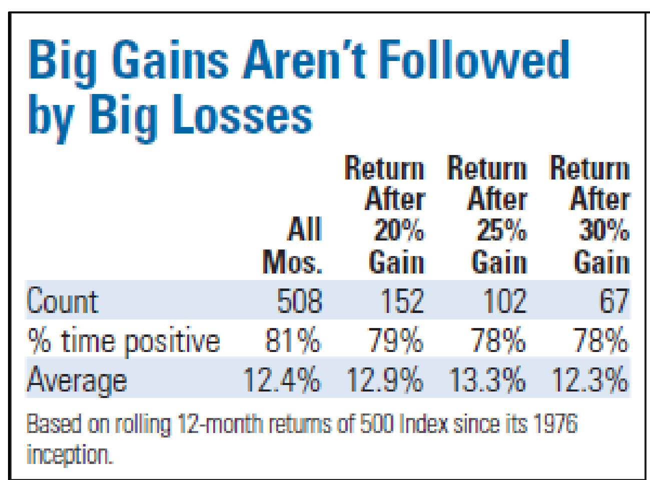
The total return of stocks in a period is comprised of the starting dividend yield, growth in earnings in the period and price earnings multiple expansion i.e. the market offering a higher price for a dollar of earnings. In 2019, with near zero earnings growth and dividends contributing about 2%, most of the returns in US stocks came from price earnings multiple expansion as seen in Fig7. However, taking a step back, since 2005, earnings growth has been the major contributor to stock returns. Surprisingly (to most people) the bull market since 2010 during which stocks averaged 13% annual returns, was also supported more by earnings growth (~90% of the returns) and dividends (~16% of the returns) than multiple expansion (only 4% of the returns). It is a bit different in Europe where earnings growth has been muted in the last decade. However, corporate earnings in Europe are below their long-term average and can be expected to rise in the future.

Fig 7: Contributors to global stock performance.



Source: JP Morgan

Fig 8: Historical stock performance after big gains



Big Gains Aren't Followed by Big Losses

	All Mos.	Return After 20% Gain	Return After 25% Gain	Return After 30% Gain
Count	508	152	102	67
% time positive	81%	79%	78%	78%
Average	12.4%	12.9%	13.3%	12.3%

Based on rolling 12-month returns of 500 Index since its 1976 inception.

Source: The Independent Vanguard Advisor

Currently, the forward price earnings multiple for US stocks is 19, which is above the 10-year and 25-year average, making stocks more expensive than in the past. Going forward, earnings growth and dividend yield combined should contribute more to stock returns than price earnings multiple expansion. Current dividend yield is about 2% and earnings are expected to grow by mid-single digits, so stock returns in the future should be modest as compared to the recent past.

One of the questions that is on most investors' minds is whether stocks can rise further after a strong 2019. As seen in Fig 8, historically, on average, strong positive stock performance is not followed by losses, so big gains are not by itself a reason for a correction. As we have discussed in the past (See 2Q 2017 letter here), stocks exhibit tremendous momentum, especially during the last stages of a bull market. In trying to avoid losses down the line investors tend to sell early giving up so much of the upside that the opportunity cost of waiting for a crash is too high. A better approach is to build a diversified portfolio matching one's risk profile and objectives and sticking with it. Additional value can be added by picking the right investment vehicles and having a thoughtful rebalancing strategy.

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